

# Taxation: New Tax Rules Permitting Limited Deferral of Unearned Income

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## COMMENTS

### NEW TAX RULES PERMITTING LIMITED DEFERRAL OF UNEARNED INCOME

#### I. INTRODUCTION

In 1970, the Commissioner of Internal Revenue partially reversed his former position which had required accrual taxpayers to include their unearned advances in income in the year of receipt. Now certain accrual taxpayers will be allowed a limited deferral of their unearned income. Revenue Procedure 71-21<sup>1</sup> permits accrual taxpayers to defer for one year the portion of advance receipts allocable to the *services* to be performed in the next year. Treasury Regulation 1.451-5<sup>2</sup> allows taxpayers selling inventoriable *goods* to defer advance payments until the second year following the year in which the total of advances received equals or exceeds the cost of the goods to be delivered. Where the goods are not inventoriable, the advances may be deferred until the year in which goods are actually delivered.<sup>3</sup>

This article shall address itself to the problems of accrual method taxpayers who seek to defer the reporting of the unearned portion of advance payments received for the sale of goods or the rendition of services until the year in which the corresponding performance is to occur. As used herein, the term unearned income<sup>4</sup> will refer to that portion of an advance or prepaid receipt which represents the value of the goods to be delivered or services to be rendered in a future year. As it will be assumed that the advance payment is income, the problem to be considered is *when* such payment should be included in gross income. Although this article will focus on the timing of receipts in income, the principles examined are also applicable to other timing issues, notably the timing of deductions.<sup>5</sup> As a preface to the analysis of the principles

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1. Rev. Proc. 71-21, 1971-2 CUM. BULL. 549, *superceding* Rev. Proc. 70-21, 1970-2 CUM. BULL. 501.

2. Proposed August 7, 1970, 35 Fed. Reg. 12612 (1970) and finalized March 23, 1971, T.D. 7103, 36 Fed. Reg. 5495 (1971).

3. Events other than delivery which may be used to trigger inclusion of the advance in income are shipment, buyer's acceptance or passage of title. *See* Treas. Reg. § 1.446-1(c)(1)(ii) (1957).

4. Prepaid income, a synonymous term, is used frequently by the courts and writers.

5. *See* INT. REV. CODE of 1954, §§ 162, 461. Other timing issues not herein considered

and applications of Revenue Procedure 71-21 and Treasury Regulation 1.451-5, existing case law and other background material must be briefly considered. The cases, particularly those holding in favor of the taxpayer, are important not only as historical background, but also for their value as authority for deferrals where taxpayers are unable to fit within the requirements of the new revenue procedure or regulation.

## II. BACKGROUND

Prior to the enactment of the new rules, it had been the Commissioner's position that advance payments received by an accrual taxpayer were to be included in income in the year of receipt, although the advance was unearned to the extent that the services had not been performed or the goods had not been delivered. This position, while generally sustained by the courts, has been severely criticized because it results in a distortion of income by placing accrual taxpayers on a cash basis for their unearned income.<sup>6</sup> Sound accounting principles for accrual taxpayers clearly require that income be reported when earned, not when received.<sup>7</sup>

In light of the continuing reference to the divergence between approved tax accounting methods and accepted business accounting principles, it is appropriate at this point to examine the accounting profession's official position on the treatment of unearned income. This position, set forth in the American Institute of Certified Public Accountants' *Accounting Principles*,<sup>8</sup> is as follows:

The realization principle requires that revenue be earned before it is recorded. . . . The requirement that revenue be earned

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include: Prepaid Subscription Income, INT. REV. CODE of 1954, § 455; Prepaid Membership Dues, INT. REV. CODE of 1954, § 456; Installment Sales, INT. REV. CODE of 1954, § 453; Obligations Issued at Discount, INT. REV. CODE of 1954, § 454; Trading Stamps and Coupons, Treas. Reg. § 1.451-4 (1957); Long-term Contract Method, Treas. Reg. § 1.451-3 (1957); Amortizable Bond Premium, Treas. Reg. § 1.61-12(c) (1957); and INT. REV. CODE of 1954, §§ 1311-1315, where there is a finding that an error was made in a closed tax year.

6. See Cromartie, *Clear Reflection of Income—Tax Accounting Methods v. Generally Accepted Methods*, 47 TAXES 834 (1969) [hereinafter cited as Cromartie]; Crumbley, *How Long Will the Commissioner and the Courts Ignore the Accounting Standards on the Accrual of Prepaid Income?*, 22 NAT'L TAX J. 559 (1969); Poole, *The Taxation of Prepaid Sales of Goods*, 24 TAX L. REV. 375 (1969); Kupfer, *Prepaid Income and Reserve for Related Expenses*, 27 N.Y.U. TAX INST. 631 (1969).

7. 1 CCH A.P.B. ACCOUNTING PRINCIPLES (A.I.C.P.A.) § 1026, ¶ 17 (Oct., 1970). It is anticipated that in the near future the accounting profession will reorganize its rule-making structure. Wall Street Journal, April 12, 1972, at 8, col. 1 (Midwest ed.).

8. 1 CCH A.P.B. ACCOUNTING PRINCIPLES (A.I.C.P.A.) § 1026, ¶ 17 (Oct., 1970).

becomes important, however, if money is received or amounts are billed in advance of the delivery of goods or rendering of services. For example, amounts for rent or magazine subscriptions received in advance are not treated as revenue of a period in which they are received but as revenue of the future period or periods in which they are "earned." These amounts are carried as "unearned revenue"—that is, liabilities to transfer goods or render services in the future—until the earning process is complete. The recognition of this revenue in the future period results in recording a decrease in a liability rather than an increase in an asset.

Although this method is generally employed by taxpayers for purposes of financial reporting, the courts and the Internal Revenue Service have not accepted it for tax purposes.

#### *A. The Code and Early Case Law*

Despite the traditional denial of the deferral of unearned income, it has long been the policy of the government to reconcile tax accounting methods with accepted business accounting practices. President Eisenhower expressed this policy in his state of the union and budget message of January, 1954, and specifically recommended that unearned income be taxed as it is earned rather than as it is received.<sup>9</sup> Accordingly, the Internal Revenue Code of 1954, as originally enacted, contained section 452, Prepaid Income.<sup>10</sup> This section provided for the deferral of prepaid income until earned by delivery of the goods or rendition of the services. Advance payments could be dererred for up to six years or, with the Commissioner's consent, for a longer period.

Although the transition year revenue loss resulting from the enactment of section 452 was originally expected to be around \$47 million, by 1955 the estimates of the one year loss had risen to as high as \$1 billion.<sup>11</sup> As the treasury could ill afford such a loss of revenue, section 452 was repealed retroactively in 1955.<sup>12</sup>

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9. Budget Message, Jan. 1954, Tax Recommendations Item No. 20. This recommendation is reproduced in REPEAL OF SECTIONS 452 AND 462 OF THE INTERNAL REVENUE CODE OF 1954, S. REP. NO. 372, 84th Cong., 1st Sess. 2 (1955).

10. Act of June 15, 1955, ch. 143, § 1(a), 69 Stat. 134. A related section, 462, provided a deduction for additions to reserves for estimated future expenses. Act of June 15, 1955, ch. 143 § 1(b), 69 Stat. 134.

11. See REPEAL OF SECTIONS 452 AND 462 OF THE INTERNAL REVENUE CODE OF 1954, S. REP. NO. 372, 84th Cong., 1st Sess. 2 (1955).

12. Act of June 15, 1955, ch. 143 § 1, 69 Stat. 134. Also cited as a reason for the repeal of sections 452 and 462 was the anticipated abuse of the provisions for reserves for estimated expenses. REPEAL OF SECTIONS 452 AND 462 OF THE INT. REV. CODE OF 1954, H. R. REP. NO. 293, 84th Cong., 1st Sess. 3 (1955).

As authority for the disallowance of deferrals of unearned income, the Commissioner has relied on sections 446<sup>13</sup> and 451<sup>14</sup> of the Code. Section 451 provides that items of income shall be included in the gross income for the taxable year in which they are received unless, under the accounting method employed, such amounts are properly reportable in a different year. With a few exceptions, the last part of this section was not accepted as authority for deferring unearned income. Section 446 sets forth the permissible methods of accounting and requires that taxable income be computed in accordance with the method regularly employed by the taxpayer. However, section 446(b) provides that "if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate does clearly reflect income." This discretion regarding the clear reflection of income has been the predominant authority on which the Commissioner has disallowed the deferral of unearned income.

In the earlier cases, the Commissioner most often based the exercise of his discretion on the "claim of right doctrine" as propounded in *North American Oil Consolidated v. Burnet*.<sup>15</sup> Although asserted less frequently, the "annual accounting concept" was also advanced as a basis for rejecting deferral techniques.<sup>16</sup> Based on these doctrines the Commissioner argued that as a matter of law any accrual method of accounting which did not report the full amount of advances in the year of receipt did not clearly reflect income.<sup>17</sup> The Service has enjoyed great success with this argument in the Tax Court.<sup>18</sup>

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13. Int. Rev. Code of 1939, ch. 1, § 41, 53 Stat. 24 (now INT. REV. CODE of 1954, § 446).

14. Int. Rev. Code of 1939, ch. 1, § 42, 53 Stat. 24 (now INT. REV. CODE of 1954, § 451).

15. 286 U.S. 417 (1932). See also *Healy v. Commissioner*, 345 U.S. 278 (1953), and *United States v. Lewis*, 340 U.S. 590 (1951).

16. *Security Flour Mills Co. v. Commissioner*, 321 U.S. 281 (1944); *Brown v. Helvering*, 291 U.S. 193 (1934); INT. REV. CODE of 1954, § 441. By 1960, the Commissioner had come to rely largely on the annual accounting concept, as four circuit courts had held that the "claim of right doctrine" was not applicable to the timing of income problem: *Schlude v. Commissioner*, 283 F.2d 234 (8th Cir. 1960); *Bressner Radio, Inc. v. Commissioner*, 267 F.2d 520 (2d Cir. 1959); *Schuessler v. Commissioner*, 230 F.2d 722 (5th Cir. 1956); *Beacon Publishing Co. v. Commissioner*, 218 F.2d 697 (10th Cir. 1955). These decisions held that the "claim of right doctrine" applied to questions involving a dispute over ownership of the amount and not to issues involving the time of reporting the amount admitted to be income.

17. For a good discussion of the arguments advanced on both sides see *Cromartie* 836.

18. See, e.g., *Curtis R. Andrews*, 23 T.C. 1026 (1955) (advance tuition to dance studio); *Wallace A. Moritz*, 21 T.C. 622 (1954) (advances for photo development); *National Air-*

Although somewhat beyond the scope of this article, it should be noted that taxpayers have had some success in challenging the character of the receipt by arguing that the advance was not income. The courts have allowed exclusion of amounts shown to have been received under incomplete or contingent agreements.<sup>19</sup> Advance payments received under leases are excludable only where it is established that they are security deposits as opposed to advance rent.<sup>20</sup>

However, in a series of three cases in the 1950's, taxpayers were successful in directly challenging the Commissioner on the issue of the proper time for reporting an advance payment admitted to be income. In *Beacon Publishing Company v. Commissioner*,<sup>21</sup> the tenth circuit permitted prepaid newspaper subscriptions to be deferred by an accrual taxpayer until the year in which the expenses necessary to earn the advances were incurred. The court relied on the fact that the accrual method of accounting prescribes that income is to be reported in the year in which the amount is earned or the rights become fixed. Reliance was also placed on the language in section 451(a) of the Code stating that income need not be reported in the year of receipt if the amount is properly accounted for in a different year. The court held that the Commissioner's wide discretion under section 446 of the Code could not

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lines, Inc., 9 T.C. 159 (1947) (advance ticket receipts); *South Tacoma Motor Co.*, 3 T.C. 411 (1944) (advances for automobile servicing); *Your Health Club, Inc.*, 4 T.C. 385 (1944) (advance dues); *Do All Tulsa Company*, 8 CCH Tax Ct. Mem. 343 (1949) (advances on service contracts); *Northern Illinois College of Optometry*, 2 CCH Tax Ct. Mem. 664 (1943) (advance tuition). However, as will be discussed later in the text, the Commissioner was much less successful in the appellate courts. See *Cromartie* 837. But see *Clay Sewer Pipe Ass'n v. Commissioner*, 139 F.2d 130 (3rd Cir. 1943).

19. See, e.g., *Watkins v. United States*, 287 F.2d 932 (1st Cir. 1961) (criminal case held for taxpayer to extent of advances on incomplete agreement to sell goods); *Woodlawn Park Cemetery Co.*, 16 T.C. 1067 (1951) (advances on a fully revocable agreement to provide burial space); *Veenstra & DeHaan Coal Co.*, 11 T.C. 964 (1948) (due to seller's market, taxpayer demanded advance payment for sale of coal although delivery was to be made only if sufficient coal was available).

20. Advance rent must be reported in the year of receipt. *Treas. Reg.* § 1.61-8(b) (1957). See, e.g., *New Capital Hotel, Inc. v. Commissioner*, 261 F.2d 437 (6th Cir. 1958); *South Dade Farms, Inc. v. Commissioner*, 138 F.2d 818 (5th Cir. 1943); *Jack August*, 17 T.C. 1165 (1952). Disguising advance rent as loan or as part of the sale price has been ineffective. See, e.g., *United States v. Williams*, 395 F.2d 508 (5th Cir. 1968); *Hyde Park Realty, Inc. v. Commissioner*, 211 F.2d 462 (2d Cir. 1954); *Blue Flame Gas Co.*, 54 T.C. 584 (1970). For cases holding that the advance payment was in fact a deposit securing performance of the lease see *Clinton Hotel Realty Corp. v. Commissioner*, 128 F.2d 968 (5th Cir. 1942), and *John Mantell*, 17 T.C. 1143 (1952). See also *Rev. Rul.* 67-47, 1967-1 CUM. BULL. 9.

21. 218 F.2d 697 (10th Cir. 1955), *rev'g* 21 T.C. 610 (1954).

be used to distort an accrual taxpayer's income by requiring the use of the cash method for advance payments. It was noted that since the "claim of right doctrine" presupposes a dispute as to ownership of the payment, that doctrine was not applicable to the question of *timing* of income. In 1958, three years after the decision in *Beacon*, section 455 was added to the Code making it permissible to defer prepaid subscription income.

The reasoning in *Beacon* was relied on by two other circuit courts in their decisions on the timing issue. In *Schnessler v. Commissioner*,<sup>22</sup> the fifth circuit reversed the Tax Court and allowed the taxpayer a deduction for the amount of a reserve for estimated expenses of performing guarantee obligations on furnaces sold by the taxpayer.<sup>23</sup> Also relying largely on *Beacon*, the second circuit, in *Bressner Radio, Inc. v. Commissioner*,<sup>24</sup> sustained an accrual taxpayer's method of deferring unearned income from one year contingent service contracts. Although the services were to be performed upon the customer's demand, the court ruled that the taxpayer's deferral method in fact matched expenses with related earnings and therefore was not a "purely artificial allocation."<sup>25</sup> This finding was based on the taxpayer's accounting records, which demonstrated a carefully estimated relationship between revenue and expense. Since the taxpayer's method clearly reflected income, it was held that the Commissioner could not reject the method. Although these cases may be authority for deferrals today, they must be considered in light of the subsequent Supreme Court decisions.

### B. The Supreme Court Trilogy

In the first of three Supreme Court cases, *Auto Club of Michigan v. Commissioner*,<sup>26</sup> it was held that annual membership dues paid in advance could not be deferred since the taxpayer's prorata

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22. 230 F.2d 722 (5th Cir. 1956), *rev'g* 24 T.C. 247 (1955).

23. For other cases favoring the taxpayer on time of deduction, see *Pacific Grape Products Co. v. Commissioner*, 219 F.2d 862 (9th Cir. 1955) and *Harrold v. Commissioner*, 192 F.2d 1002 (4th Cir. 1951).

24. 267 F.2d 520 (2d Cir. 1959) *rev'g* 28 T.C. 378 (1957). The Commissioner will not follow this decision. Rev. Rul. 6-85, 1960-1 CUM. BULL. 181. However, Rev. Rul. 71-299, 1971-2 CUM. BULL. 218 modified Rev. Rul. 60-85 to the extent inconsistent with Rev. Proc. 71-21.

25. "Purely artificial" is the test propounded in *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180 (1957). This was one of a trilogy of Supreme Court decisions on deferral of unearned income and all three of the cases will be discussed later in the text.

26. 353 U.S. 180 (1957).

allocation of the membership dues was purely artificial and bore no relation to the services to be rendered.<sup>27</sup> Without relying on the "claim of right doctrine," the Court determined that the rejection of the taxpayer's method was not an abuse of the Commissioner's discretion.

In *American Automobile Association v. United States*,<sup>28</sup> the Supreme Court again upheld the disallowance of the deferral of unearned automobile club dues. The Court not only relied on *Auto Club of Michigan*,<sup>29</sup> but also on the repeal of section 452 of the Code.<sup>30</sup> The Court found that the repeal of section 452 was a congressional mandate rejecting the deferral of unearned income for tax purposes. Therefore it was again found that the Commissioner had not abused his discretion by rejecting the Association's accounting method.<sup>31</sup> Immediately following this decision Congress enacted section 456<sup>32</sup> of the Code which provided for the deferral of prepaid dues income of certain membership organizations such as the American Automobile Association. Although section 456 of the Code overrules *American Automobile Association* on its facts, the principles of law set forth therein have retained their vitality down to the present day.

In *Schlude v. Commissioner*,<sup>33</sup> the taxpayer, an Arthur Murray, Inc., franchisee, attempted to defer the unearned portion of advance payments received under contracts for dance lessons. Al-

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27. *Id.* at 189. It should be noted that the deferral problem was a minor issue in this case, and, therefore, was not fully developed by the introduction into evidence of accounting data necessary to show a reasonable relationship between income and expense, as in *Bressner*.

28. 367 U.S. 687 (1961), *rehearing denied*, 368 U.S. 870 (1961). Certiorari to the Court of Claims based on the conflict between that court and the Second Circuit Court of Appeals, in *Bressner*. However, *Bressner* was not overruled, but merely distinguished on its facts, and no opinion of its correctness was stated. 367 U.S. at 687, 691 n.4.

29. Unlike the facts in *Auto Club of Michigan*, the deferral issue was fully developed by accounting data supporting the accruals. However, in *American Automobile Association*, the Supreme Court agreed with Court of Claims that although the method employed was in accord with accepted accounting standards, the taxpayer's system failed to qualify under the annual accounting concept due to the fact that performance of the service was contingent upon demand by members and could occur in the next tax year. 367 U.S. at 690-92.

30. Act of June 15, 1955, ch. 143, § 1, 69 Stat. 134.

31. However, the repeal was not intended to have any effect on prior law. H.R. REP. NO. 293, 84th Cong., 1st Sess. 4-5 (1955). The Court ignored this expression of intent and stated that "the cold fact is that it repealed the only law incontestably permitting the practice upon which the Association depends." 367 U.S. at 695.

32. INT. REV. CODE OF 1954, § 456 ("Prepaid Dues Income of Certain Membership Organizations").

33. 372 U.S. 128 (1963).



though the contracts provided for a set number of lessons within a certain period of time, the exact dates for the lessons were to be arranged by the pupil and the instructor. Relying on *American Automobile Association*,<sup>34</sup> the Court based its decision on the congressional mandate against deferrals implicit in the repeal of section 452 and a finding that the taxpayer's method of accounting for services to be rendered upon demand was artificial.<sup>35</sup>

These three Supreme Court decisions stand for the proposition that, absent contrary statutory provisions, it is not an abuse of the Commissioner's discretion to disallow the deferral of unearned income, at least where the taxpayer's accounting method fails to show a reasonably certain relationship between the amount deferred and the future performance. The Commissioner has enjoyed resounding success in the application of the Supreme Court decisions.

### C. *Application of the Supreme Court Trilogy*

The lower courts had no difficulty finding that the Supreme Court decisions controlled virtually every case involving the deferral of unearned income from service contracts.<sup>36</sup> The courts also

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34. The Court noted that, despite the enactment of INT. REV. CODE of 1954, § 456, The Principles of *American Automobile Association* were fully applicable here.

35. It should be noted that the taxpayer's method attempted to correlate income and expense by including in income each year an amount corresponding to the number of lessons given to each pupil. However, the Court noted that fixed expenses such as commissions were not accrued but were deducted in the first year of the contract. 372 U.S. at 132.

36. See *E. Morris Cox*, 43 T.C. 448 (1965) (prepaid investment management services), and *Paul B. Huebner*, 25 CCH Tax Ct. Mem. 406 (1966) (prepaid legal fees). For cases involving a mixture of rent and services, see *Parchester Beach Club Corp. v. Commissioner*, 335 F.2d 478 (2d Cir. 1964) (beach club dues) and *Wild Acres Rest Home, Inc.*, 26 CCH Tax Ct. Mem. 391 (1967) (lump sum prepayment for rest home care). In *New England Tank Indus. of New Hampshire, Inc. v. Commissioner*, 413 F.2d 1038 (1st Cir. 1969), advance payment to build and rent storage tanks was held to be rent, as taxpayer failed to segregate the advance for rent from the advance for services, therefore the total amount was includable at receipt under Treas. Reg. § 1.61-8(b) (1957). But see *Petroleum Heat and Power Co., Inc. v. United States*, 405 F.2d 1300 (Ct. Cl. 1969) involving prepaid service contracts to overhaul furnaces, wherein the court found for the taxpayer and deferral was permitted within one year from a short period to the next tax year. For cases disallowing deferrals under warranty contracts see *Bell Electric Co.*, 45 T.C. 158 (1965) and *L.L. Crosby*, 35 T.C. 739 (1961). For cases involving sale of coupons for services to be performed in the future, see *Automobile Club of New York, Inc. v. Commissioner*, 304 F.2d 781 (2d Cir. 1962) and *P. F. Scheideman & Sons, Inc.*, 24 CCH Tax Ct. Mem. 168 (1965). For cases involving advances received on pre-need funeral plans, see *Angelus Funeral Home v. Commissioner*, 407 F.2d 210 (9th Cir. 1969); *Hamilton Memorial Gardens, Inc. v. Commissioner*, 394 F.2d 905 (6th Cir. 1968); *Jefferson Memorial Gardens, Inc. v. Commissioner*, 390 F.2d 161 (5th Cir. 1968); and *Prichard Funeral Home, Inc.*, 21 CCH Tax Ct. Mem. 1399 (1962).

held that the *American Automobile Association* and *Schlude* decisions controlled other timing questions, notably the timing of deductions.<sup>37</sup>

Taxpayers seeking to defer advance payments received for the sale of goods attempted to distinguish their cases on the basis that the Supreme Court decisions involved contracts for the rendition of services. It was argued that requiring the advance payments to be included in income in the year of receipt was an unconstitutional tax on gross receipts and a denial of the return of capital concept.<sup>38</sup> However, in *Fifth and York Company v. United States*,<sup>39</sup> the court decided that the reasoning in *Schlude* controlled the treatment of advance payments for the sale of goods. Since section 452 of the Code applied to sale of goods as well as service contracts, it was held that the congressional mandate against the deferral of unearned income was also applicable to advance payments for the sale of goods.<sup>40</sup>

A problem of more current interest is the effect of the Supreme Court decisions on the holdings of *Beacon*, *Schuessler* and *Bressner*. It is interesting that the Supreme Court in both *Auto*

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37. As soon as it was clear that unearned income could not be deferred, taxpayers took up the argument that there should be allowed a deduction for future expenses. However, the courts held that the three Supreme Court cases also controlled this issue, and the deductions for future expenses were denied. See *McAllister v. Commissioner*, 417 F.2d 581 (9th Cir. 1969) (value of future refunds of insurance sales commissions); *Villafranca v. Commissioner*, 359 F.2d 849 (6th Cir. 1966) (cost of future dancing lessons); *Streight Radio and Television, Inc. v. Commissioner*, 280 F.2d 883 (7th Cir. 1960) (cost of service contract); *Simplified Tax Records, Inc.*, 41 T.C. 75 (1963) (cost of tax return preparation); and *Bernard J. Husnik*, 28 CCH Tax Ct. Mem. 163 (1969) (cost of discount food coupons).

38. For a good discussion of these problems, see Poole, *The Taxation of Prepaid Sales of Goods*, 24 TAX L. REV. 375 (1969), and Comment, *The Prepaid Income Rule: Constitutional and Practical Aspects of Its Application To the Sale of Goods*, 21 MIAMI L. REV. 866 (1967).

39. 234 F. Supp. 421 (W.D. Ky. 1964). The case involved a two for one sale of automobiles where first year price included another car to be delivered in the next year.

40. *Id.* at 424. For other cases involving sale of goods, see *Martin v. United States*, 411 F.2d 1164 (8th Cir. 1969) (suit club); *Hagen Advertising Displays, Inc. v. Commissioner*, 407 F.2d 1105 (6th Cir. 1969), *aff'g* 47 T.C. 139 (1966) (advertising signs); *S. Garber, Inc.*, 51 T.C. 733 (1969) (custom-made fur coats); *Chester Farrara*, 44 T.C. 189 (1965) (suit club); *Modernaire Interiors, Inc.*, 27 CCH Tax Ct. Mem. 1334 (1968) (custom-made furniture). But see *Consolidated Hammer Dry Plate & Film Co. v. Commissioner*, 317 F.2d 829 (7th Cir. 1963), wherein the taxpayer prevailed because a contract to produce cameras, from which advances were received, was contingent and incomplete (see note 19 *supra*). Where the taxpayer could not come within the requirements of INT. REV. CODE of 1954, § 455, it was held that the rule of *Schlude* controlled the prepaid subscription income. *Decision, Inc.*, 47 T.C. 58 (1966) (advance subscriptions for a job directory); *William O. McMahon*, 45 T.C. 221 (1965) (bulletins on automobile values).

*Club of Michigan*<sup>41</sup> and *American Automobile Association*<sup>42</sup> merely distinguished *Beacon* and *Scheussler* on their facts and refused to express an opinion on the correctness of the lower court decisions. In *Schlude* the circuit court opinions were not mentioned. However, from the Tax Court's statement in *Bell Electric Co. v. Commissioner*,<sup>43</sup> that "they [*Beacon*, *Schuessler* and *Bressner*] must be considered in light of the subsequent authoritative decisions of the Supreme Court", it appears that the prior circuit court decisions have lost much of their vitality. Irrespective of the present strength of *Beacon* and *Bressner* and the overall success of the Commissioner in the application of the Supreme Court trilogy, there is current authority for the deferral of unearned income where the taxpayer cannot meet the requirements of Revenue Procedure 71-21 or Treasury Regulation 1.451-5.

#### D. *The Artnell Decision*

In *Artnell Company v. Commissioner*,<sup>44</sup> the seventh circuit found that the Supreme Court had left an opening for a decision that where the *time* and *extent* of the future performance was so certain that a method of deferring unearned income could clearly reflect income the Commissioner's rejection of such method would constitute an abuse of discretion. The case involved the receipts from season tickets sold by the Chicago White Sox baseball team. Since the tax year involved ended on May 31, the White Sox sought to defer that portion of the season ticket receipts which corresponded to the games to be played after the end of the tax year. The court distinguished the prior Supreme Court decisions on the basis of certainty of time and extent of performance.<sup>45</sup> The facts in *Artnell* were found to be more closely analogous to the permissible deferral of prepaid subscription income<sup>46</sup> than to the situations considered in *American Automobile Association* and *Schlude*. Finding that there must be situations in which deferral techniques do clearly reflect income, the court reversed and remanded the case to the Tax Court for a determination of whether the White Sox' method in fact clearly reflected income. On re-

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41. 353 U.S. at 189 n.20.

42. 367 U.S. at 691 n.4.

43. 45 T.C. 158, 166 (1965).

44. 400 F.2d 981 (7th Cir. 1968), *rev'g* 48 T.C. 411 (1967).

45. The Seventh Circuit placed little weight on the uncertainty of dates resulting from rain-outs. 400 F.2d at 984.

46. INT. REV. CODE of 1954, § 455.

mand,<sup>47</sup> the Tax Court relied on generally accepted accounting principles<sup>48</sup> and found in favor of the taxpayer. The court noted that the White Sox method of accounting was not a perfect reflection of income in that 38 percent of the expenses were deducted in the initial period in which only 31 percent of the games were played. Fortunately for the taxpayer, however, the alternative method suggested by the Service—that all of the season ticket receipts should be included in income in the initial period—clearly was erroneous.<sup>49</sup> Despite this finding, it appears from a close reading of the two *Artnell* opinions that the taxpayer need only show that *his* method of accounting clearly reflects income, and upon such a showing he need not address himself to the method advanced by the Commissioner.

At least in the seventh circuit, and probably elsewhere, taxpayers, upon a showing of requisite certainty of the time and extent of future performance, may defer the unearned portion of advance payments. Although the facts of *Artnell* involved services, presumably the rule applies equally to advances for the sale of goods. However, taxpayers need not establish the requisite degree of certainty where their advance payments qualify for deferral under Revenue Procedure 71-21 or Treasury Regulation 1.451-5.

### III. REVENUE PROCEDURE 71-21 AND TREASURY REGULATION 1.451-5

Revenue Procedure 71-21<sup>50</sup> was promulgated by the Commissioner in furtherance of the policy to reconcile tax and financial accounting treatment of unearned income.<sup>51</sup> The Commissioner has exercised the discretion vested in him pursuant to section 446 of the Code to allow certain accrual method taxpayers to defer for one year the inclusion of unearned income from *services* to be

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47. *Artnell Company*, 29 CCH Tax Ct. Mem. 403 (1970).

48. As neither party offered expert testimony as to accepted business accounting practices, the court acted on its own concept of sound accounting principles. 29 CCH Tax Ct. Mem. at 405.

49. The petitioner has the burden of proof, and although it has failed to prove that the White Sox method of accounting perfectly reflected its income, it has shown that the respondent's method is erroneous. . . . Often, we accept the respondent's judgment in the selection of a method of accounting that will clearly reflect income, but there is no justification for doing so when his method clearly is less desirable than that of the petitioner.

29 CCH Tax Ct. Mem. at 406.

50. 1971-2 CUM. BULL. 549, *superceding* Rev. Proc. 70-21, 1970-2 CUM. BULL. 501.

51. Rev. Proc. 71-21 § 2.

rendered.<sup>52</sup> The agreement under which the advance payment is received must require that performance of the services be completed within the next tax year following the year of receipt.<sup>53</sup> Unearned income from contingent service agreements will qualify for deferral where, if the taxpayer sells, leases or installs the property to be serviced, such property is offered for sale, lease or installation without the contingent service contract.<sup>54</sup>

Advance payments for the sale of *goods* to be delivered in the future may be deferred under new Treasury Regulation 1.451-5.<sup>55</sup> Although in a few situations the regulation permits deferral until delivery, most taxpayers will be controlled by the so-called exception for inventorable goods on hand or available.<sup>56</sup> Under this exception the taxpayer must include advance payments in income by the end of the second tax year following the year in which the total advances equal or exceed the cost of the goods to be delivered.<sup>57</sup>

The balance of this article will examine these new rules, noting areas in need of clarification, pose problems in the application of the new rules and suggest possible solutions to those problems.

### A. *Transitional Rules*

Both of the new rules apply only to taxpayers using the accrual method of accounting.<sup>58</sup> However, most taxpayers desiring the benefits of the regulation are required to maintain an inventory<sup>59</sup> and therefore will already be using the accrual method.<sup>60</sup> Since the regulation only requires an accrual method for purchases and sales,<sup>61</sup> taxpayers may use the combination of methods under section 446(c)(4) of the Code.<sup>62</sup> The revenue procedure is slightly more

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52. *Id.* § 1.

53. *Id.* § 3.02. But see the limited exceptions under §§ 3.04 and 3.05, to be discussed later in the text.

54. *Id.* § 3.07.

55. The Regulation also applies to long-term contracts, and therefore all principles applicable to sale of goods also apply to long-term contracts. *See also*, Treas. Reg. § 1.451-3 (1971) ("Long-term Contracts").

56. Treas. Reg. § 1.451-5(c) (1971).

57. Treas. Reg. § 1.451-5(c) (3) (1971).

58. Rev. Proc. 71-21 § 3.02; Treas. Reg. § 1.451-5(a)(1) (1971).

59. INT. REV. CODE of 1954, §§ 471, 472.

60. Treas. Reg. § 1.446-1(c)(2)(i) (1957).

61. Treas. Reg. § 1.451-5(a)(1) (1971). However, the regulation is applicable only to sales of goods held by the taxpayer primarily for sale to customers in the ordinary course of business.

62. Treas. Reg. § 1.446-1(c) (1) (iv) (1957).

restrictive in that it requires the total use of the accrual method of accounting.<sup>63</sup>

However, it may not be necessary for taxpayers to use the accrual method for all purposes. If the taxpayer is engaged in more than one business it should be necessary to adopt the accrual method only for that segment in which the taxpayer seeks to defer unearned income.<sup>64</sup> For example, an attorney who also teaches a bar review course could defer advance tuition,<sup>65</sup> or a professor who is also an author may be able to defer advance payments for books to be written.

Both the new revenue procedure and regulation are treated as methods of accounting<sup>66</sup> and, therefore, the adoption of either rule is a change of accounting method within the meaning of sections 446 and 481 of the Code.<sup>67</sup> The problem created by treating the adoption of these new rules as a change of accounting method is that the Commissioner must consent to the change.<sup>68</sup> In order to secure consent, the taxpayer must agree to take into account resulting adjustments in a manner satisfactory to the Commissioner.<sup>69</sup> However, the new regulation provides that taxpayers already using the method therein prescribed need not apply for a change of method.<sup>70</sup> Although it is not so provided, it appears that this rule will also apply to taxpayers already reporting under the method prescribed in Revenue Procedure 71-21.<sup>71</sup>

Revenue Procedure 70-27<sup>72</sup> outlines the basic requisites for obtaining the Commissioner's consent. Taxpayers seeking to change accounting methods must file form 3115 (application for change of accounting method) with the Commissioner within 180 days of

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63. Rev. Proc. 71-21 § 3.02.

64. INT. REV. CODE OF 1954, § 446(d); Treas. Reg. § 1.446-1 (d) (1957).

65. See Sobeloff, *New Prepaid Income Rules: IRS Reversal of Position Will Aid Many Taxpayers*, 33 J. TAXATION 194, 195 (1970) [hereinafter cited as Sobeloff].

66. Rev. Proc. 71-21, § 3.14; Treas. Reg. § 1.451-5(e) (1971).

67. Rev. Proc. 71-21 § 5.01, Treas. Reg. § 1.451-5(e) (1971).

68. INT. REV. CODE OF 1954, § 446(e); Treas. Reg. § 1.446-1(e)(2) (1957).

69. See Rev. Proc. 70-27, 1970-2 Cum. Bull. 509, to be discussed later in the text.

70. Treas. Reg. § 1.451-5(e)(2) (1971). For taxable year ending in 1970, taxpayers could have applied for consent to change to the new method even after their returns were filed if Form 3115 was filed within 180 days after March 13, 1971. Treas. Reg. § 1.451-5(e)(1) (1971).

71. This result may be inferred from Rev. Proc. 71-21 §§ 3.14, 5.01.

72. 1970-2 CUM. BULL. 509. For a general discussion of Rev. Proc. 70-27, see Sanders, *Final Rules on Accounting Method Changes Represent a Much Needed Clarification*, 34 J. TAXATION 116 (1971).

the beginning of the proposed year of change.<sup>73</sup> The real problem arising from a change of method is that resulting adjustments must be spread over an appropriate period, usually ten years.<sup>74</sup>

Adjustments arising from the change of methods will be a result of the double inclusion of the portion of the advance payments earned after the year of receipt. Prior to the year of change the taxpayer will have included all advances in income in the year of receipt. Beginning in the year of change receipts must be included in income as they are earned and, therefore, some of the payments received and included in prior years must again be included when earned in the year of change. The Commissioner could require that the amount doubly included be deducted ratably over a ten year period. For example, assume a taxpayer, under an otherwise qualified agreement, is obligated to render services over a two year period, forty percent to be completed in year one and the remaining sixty percent to be performed in year two. Assume further that full payment of \$100 is received in year one. In accordance with the old method of reporting advance payments at receipt, the full payment was included in income in year one. If, in year two, the taxpayer applies for a change to the method prescribed in Revenue Procedure 71-21 there will be a resulting adjustment of \$60. Since in the year of change income must be reported as earned, the taxpayer will report in year two the \$60 earned that year despite the fact that this amount has already been reported as part of the \$100 of income in year one. The \$60 adjustment for the amount included twice will be spread out over ten years allowing the taxpayer an extra \$6 deduction in year two and the following nine years.<sup>75</sup> However, the Commissioner could permit the adjustments to be taken into account over a shorter period, or perhaps even allow the adjustments to be fully accounted for in the year of change. The terms of the consent agreement will be determined on a case-by-case basis depending on the usual subjective factors considered in any other settlement. However, since advances received in the year of change will be deferrable without adjustment, the adoption of the deferral method will result in some one year loss of revenue. Since this loss could be reduced by spreading the adjustments, it is anticipated that the Commissioner will generally

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73. Rev. Proc. 70-27 §§ 2, 4.01. For good cause the time limit may be extended to nine months. *Id.* § 4.02.

74. *Id.* §§ 3.01, 4.01.

75. For another example, see Sobeloff at 195.

require that taxpayers account for their adjustments over the full ten year period.

Taxpayers could avoid the effects of these transitional rules by shifting the business activities which generate the unearned income to newly created members of the taxpayers' controlled groups. Since such new members may adopt any permissible method of accounting without consent,<sup>76</sup> the controlled group could circumvent the transitional rules. The revenue procedure has effectively prevented this manipulation to some extent, however, by enlarging the definition of a change of accounting method to encompass situations where related persons (as defined in section 482 of the Code) have performed services similar to those offered by the taxpayer within any of the five years preceding the year of adoption by the taxpayer.<sup>77</sup>

Another way to avoid the ten year spread, rather than creating a new related taxpayer, is by becoming an *artificially* new taxpayer by eliminating the unearned income account before the year of change. If the unearned income account can be eliminated, there will be no resulting adjustments. Current unearned income may be disposed of by renegotiating existing contracts so that, as of the year of change, they become, in effect, new obligations qualifying for deferral treatment. Alternatively, since by the year of change advances on existing obligations have already been reported at receipt, existing service contracts could be extended beyond the time limit of the revenue procedure, thereby avoiding the double inclusion. The taxpayer could also pay a third party to assume the prior obligations.<sup>78</sup>

One obvious problem is that such manipulations may cause the Commissioner to withhold his consent to the change of method. Although the taxpayer may sue to compel consent, this would be practical only where there are substantial tax savings at stake. Perhaps the only effective way to avoid the adjustment spread is to delay adoption of the new method until the unearned income account has been naturally eliminated by the performance of all prior obligations. Under this method the taxpayer could not accept advance payments under new obligations until such time as per-

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76. Treas. Reg. § 1.446-1(e)(1)(1957). The method prescribed in Rev. Proc. 71-21 is an acceptable method of accounting. Rev. Proc. 71-21 § 3.14.

77. Rev. Proc. 71-21 § 5.01. This provision was not contained in Rev. Proc. 70-21.

78. See Sobeloff 195.



formance is completed on existing contracts qualifying for deferral.<sup>79</sup> Although taxpayers seeking to adopt the revenue procedure need only refuse advances for one year, if this method is unacceptable, as probably will be the case for those selling goods, it appears that the adjustment spread will be unavoidable.

### *B. General Requirements of the New Rules*

Although under the new revenue procedure the underlying agreements may be oral,<sup>80</sup> it is suggested that all such agreements be reduced to writing, as it may be necessary later to establish the fact that the services were required to be rendered by the end of the tax year following the year of receipt.<sup>81</sup> Taxpayers must also maintain adequate books and records to verify the deferrals.<sup>82</sup> Although the new regulation does not require a writing, contracts for the sale of goods will generally be reduced to writing under the provisions of the Uniform Commercial Code.<sup>83</sup> The regulation also requires taxpayers to file an information schedule with each return.<sup>84</sup> This schedule must set forth the total advance payments received in the current year, the total advance payments received in past years but not yet included in income, and the total of such advance payments included in current income. The preparation of such a schedule should cast no real burden on taxpayers, as the supporting workpapers will be needed to prepare other financial statements.

Generally, under both of the new methods, income is to be reported when earned according to the method of accounting consistently employed by the taxpayer.<sup>85</sup> Income from contingent service contracts may be reported on: a statistical basis, if adequate data is available; a straight-line basis, if it is not unreasonable to anticipate that ratable portions of the services will be performed each tax year; or any other basis which, in the opinion of the

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79. Where service contracts extend beyond the one year limit there will be no adjustments, as they do not qualify for deferrals and the receipts will not be again reported as earned.

80. Rev. Proc. 71-21 § 3.02.

81. *Id.*

82. *Id.* § 4.

83. Uniform Commercial Code § 2-201.

84. Treas. Reg. § 1.451-5(d) (1971).

85. Rev. Proc. 71-21 §§ 3.11, 3.14; Treas. Reg. § 1.451-5(b)(2) (1971). Including advance payments in the year of receipt is, of course, always permissible. Rev. Proc. 71-21 § 3.01; Treas. Reg. § 1.451-5(b) (1) (1971).

Commissioner, clearly reflects income.<sup>86</sup> Under both rules advances are considered received when they become due and payable.<sup>87</sup>

The new revenue procedure, by its one year limitation, disqualifies advances received under agreements providing that some portion of the services are to be performed either at a time beyond the one year limit or at an unspecified date which may be beyond the time limit.<sup>88</sup> If, for any reason, the services under a qualified agreement are in fact performed at a time beyond the one year limit, all receipts must be included by the end of the year following the year of first receipt.<sup>89</sup> Bus tokens or transportation tickets with open dates<sup>90</sup> and certificates or other evidence of a prepaid obligation to process photographic materials<sup>91</sup> need not require complete performance within the next year. However, regardless of when the tokens or photo certificates are actually redeemed, the advances must be included in income by the end of the tax year following the year of receipt.<sup>92</sup>

If a taxpayer utilizing either of the new rules dies or ceases to exist,<sup>93</sup> or liability under the agreement otherwise ends, all advances not previously included must be included in income in the year of cessation of the taxpayer's liability.<sup>94</sup> A related problem under these provisions is the entitlement to and the timing of the deduction for related expenses.<sup>95</sup> A taxpayer merely ceasing to be liable on an obligation, but not dying, may be able to accelerate related expenses into the tax year in which the advance is included upon providing sufficient safeguards against a later double deduc-

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86. Rev. Proc. 71-21 § 3.06. This provision was not contained in Rev. Proc. 70-21.

87. Treas. Reg. § 1.451-5 (a) (2) (ii) (1971); Rev. Proc. 71-21 § 1.

88. Rev. Proc. 71-21 § 3.03.

89. *Id.* § 3.02.

90. *Id.* § 3.04.

91. *Id.* § 3.05. This exception was not contained in Rev. Proc. 70-21. For a case where this provision would have affected the result see Wallace A. Moritz, 21 T.C. 622 (1954).

92. Rev. Proc. §§ 3.04, 3.05.

93. Other than in a transaction to which INT. REV. CODE of 1954, § 381(a) applies (carryovers in certain corporate acquisitions).

94. Treas. Reg. § 1.451-5(f)(1971); Rev. Proc. 71-21 § 3.13. Interestingly, both sections, by the language "dies, ceases to exist . . . or liability under the agreement otherwise ends," apparently presuppose that death ends the taxpayer's liability. Although these provisions merely require that all advance payments be included in the final return, it should be noted that in the case of the taxpayer's death, his personal representative will be liable, in some instances, to perform the existing obligations and, in others, to refund the advance payments.

95. For a discussion of this matter see Sobeloff at 197.

tion. However, if the taxpayer dies, deductions for corresponding expenses may not be accelerated into the last return.<sup>96</sup> This problem can be cured at the time of negotiating by establishing a price at which the successor will take up the unperformed obligations.<sup>97</sup>

Perhaps the most difficult requirement to comply with is the so-called booking rule. Both new methods require that accruals are to be in accordance with the methods used for purposes of *all* reports (including consolidated financial statements) to shareholders, partners, other proprietors, beneficiaries and for credit purposes.<sup>98</sup> To be eligible for the new rules, many taxpayers will have to reorganize their financial reporting systems to conform all of their statements to the desired tax treatment. Since both rules use the terms "all reports and statements" it appears that a single statement to a creditor could affect eligibility for the new rules. The failure to defer an advance payment on any statement may trigger the inclusion of that advance in the year of receipt. If, on any statement, the taxpayer reports the advance upon receipt and accelerates a reserve for related expenses, thereby merely including only the gross profit, the full amount of the advance will have been included in gross income and therefore deferral treatment will almost certainly be denied.<sup>99</sup>

Unfortunately, many otherwise eligible taxpayers who will not permit tax accounting methods to dictate the methods used for financial reporting will lose the benefits of these new rules. Although to be acceptable a method of accounting must clearly reflect income, the door is open for manipulation or use of arbitrary figures in the taxpayer's books which will be controlling for tax purposes. It has been suggested<sup>100</sup> that the validity of this booking rule requirement is questionable, as there is an absence of specific statutory authorization for such a far reaching requirement. Even considering that hearings are held before the finalization of a regu-

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96. Treas. Reg. § 1.461-1(b) (1957).

97. A related problem is that of unclaimed goods and services. Rev. Proc. 71-21 provides a solution by requiring inclusion of all advances by the end of the tax year next succeeding the year of receipt. This rule also applies to open-date bus tokens and prepaid photo development obligations. There may be a problem where gift certificates are not redeemed. However, gift certificates are covered by the inventoriable goods exception of the regulation and the problems connected therewith will be examined later.

98. Rev. Proc. 71-21 § 3.11; Treas. Reg. § 1.451-5(b) (2) (1971). Rev. Proc. 71-21 § 3.11 differs slightly from the regulation in that it states that taxpayers shall include "no less than the amount of such payment included" for all reports.

99. For a good discussion of the booking rule see Sobeloff at 199-200.

100. *Id.*

lation and that the new revenue procedure is merely an exercise of the discretion vested in the Commissioner, it appears that the booking rule has an unreasonably far reaching effect on taxpayers' financial accounting systems. This result could be neutralized to some extent through a liberal construction of the terms "all reports and statements."

### *C. Other Problems Under the Revenue Procedure*

The Commissioner apparently feared that taxpayers would abuse the new method by securing the deferral of advances beyond the one year limit through the use of consecutive two year agreements distributed over a group of related taxpayers. To prevent this, the term "agreement," as used in the new revenue procedure, includes other agreements between the taxpayer or related persons and the recipients of the benefits of the performance under the initial agreement where such other agreements provide for the rendition of similar services over a period of time that is substantially consecutive to that of the original agreement.<sup>101</sup> "Related person" is defined as any other person owned or controlled directly or indirectly by the same interests within the meaning of section 482 of the Code.<sup>102</sup> Apparently this provision will effectively prevent the use of consecutive two year agreements spread over a control group as a device for extending the time limitation of the revenue procedure. Presumably, the definition of agreement also includes option contracts as well as short year agreements such as service contracts on air conditioners for only the months of June through August. Therefore, it appears that taxpayers desiring full deferral of advances from long term service arrangements will have to settle for a mere expectation of renewal. This may be acceptable where the customers, though not legally obligated to renew, are, practically speaking, unlikely to switch to a competitor.

There is a limited alternative available to taxpayers who find it unacceptable to rely on a mere expectation of renewal. The new revenue procedure applies to agreements as they exist at the end of the taxable year of receipt.<sup>103</sup> Since the date of execution of the agreement is irrelevant, it should be permissible to consider the next to last year covered by the agreement as the year of receipt.

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101. Rev. Proc. 71-21 § 3.09.

102. *Id.* § 3.10. See Treas. Reg. § 1.482-1(a) (1962). Generally, references to taxpayers include related persons. Rev. Proc. 71-21 §§ 3.07, 3.09, 5.01.

103. Rev. Proc. 71-21 § 3.02.

By testing the agreement as of the receipt of the payment due in the second to last year of the agreement, it appears possible to defer for one year the unearned portion of such payment even though the agreement as a whole exceeds the time limitations of the revenue procedure. However, such lengthy agreements will provide tax savings only where the non-deferrable advances received in the initial years are either minimal in amount or so restricted as to use that they are in fact mere security deposits.<sup>104</sup> Due to cash flow problems, such agreements also must require only a minimal outlay for expenses in the initial years.

There is a question as to the proper method of allocating the advances to the tax years involved. If the advance payments are allocated on the first-in, first-out (fifo) basis, taxpayers should be able to secure deferral treatment for the last two years covered by the agreement.<sup>105</sup> For example, assume that a contract covers three years and that five percent of the services are to be rendered in the first year, fifty-five percent the second year and forty percent the third year. The total contract price is \$10,000 of which \$1,500 is due in the first year, \$7,500 in the second year and \$1,000 the third year. Since the contract is to be tested as of the time of each receipt, a problem will arise only if part of the advance received in the first year is allocated to the third year, thereby extending the years involved beyond the one year limit. However, if the allocation is on the fifo basis, the payment received in the first year will be earned over the first two years and be reported as income upon receipt in year one. Therefore, the agreement as of the receipt of the advance in year two will meet the requirements of the new rules and the unearned portion of the payment received in year two may be deferred to year three. Assuming that the fifo method is used in the above example, \$1,500 will be reported at receipt in year one with \$1,000 of it (the excess of payment over percent earned in year one) to be part of the amount earned in year two. For year two, \$3,000 of the receipt is deferred to year three when that amount plus the \$1,000 received in year three will constitute the third year's income. The fifo method appears to be the most sound reporting basis, and if accepted by the Service and the courts, taxpayers will be able to defer advances received in the next to last year under service agreements exceeding the one year limit.

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104. See notes 19 and 20 *supra*.

105. For a thorough analysis and example of this problem, see Battle, *Advance Payments for Services: Limited Deferral Permitted*, 57 A.B.A.J. 182, 184-85 (1971).

As noted above, income from contingent service contracts is eligible for deferral and may be reported on a statistical basis, a straight line basis or any other method which clearly reflects income.<sup>106</sup> Deferral is permitted even though the agreement includes an obligation to replace parts or materials where such obligation is merely incidental to the main agreement providing for the performance of services.<sup>107</sup> Hopefully, the term "incidental" will be construed liberally, thereby maximizing the application of the new revenue procedure.

Unlike its predecessor of 1970,<sup>108</sup> Revenue Procedure 71-21 permits the deferral of advances from contingent service contracts where the taxpayer sells, leases, builds, installs or constructs the property subject to the service agreement. However, the taxpayer, in the normal course of business, must also offer to sell, lease, build, install or construct the property without a contingent service agreement.<sup>109</sup> Does the language "in the normal course of business" cover the situation where a taxpayer, selling and servicing elevators, will sell an elevator at a discount if the customer also purchases a service contract? In the elevator business, as well as many other fields, it is often the practice to sell the elevator at cost if a profitable service contract can be secured. This type of sales policy may be less desirable because service contracts eligible for deferral must be limited to two years, and the mere expectation of renewal may not be sufficient security.

It should also be noted that guarantee or warranty contracts are excluded from the benefits of the new revenue procedure.<sup>110</sup> The reason given for excluding warranties and guarantees is the difficulty in formulating adequate rules necessary to administer such provisions. However, this problem is under consideration by the Service.<sup>111</sup> For the time being, it is suggested that taxpayers exercise care to insure that their contingent service agreements do not technically become warranty or guarantee contracts.

As has been the rule for many years, advance rentals must be included in income in the year of receipt regardless of the period

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106. Rev. Proc. 71-21 § 3.06.

107. *Id.* § 3.07.

108. Rev. Proc. 70-21 § 3.05.

109. Rev. Proc. 71-21 § 3.07.

110. *Id.* § 3.08. *But see* Schuessler v. Commissioner, 230 F.2d 722 (5th Cir. 1956) allowing a deduction for a reserve to cover future warranty obligations on furnaces sold by the taxpayer. For other warranty cases holding for the Commissioner, see note 36 *supra*.

111. IRS Technical Information Release 1055 (August 6, 1970).

covered or the method of accounting employed by the taxpayer.<sup>112</sup> The new revenue procedure also adopts this rule, as advance rentals are specifically excluded from its scope. However, in situations involving a mixture of rent and services, the Commissioner appears to be taking a liberal position. The new method provides that payments for use or occupancy of rooms or other space where significant services are also rendered to the occupants are not deemed advance rentals.<sup>113</sup> Also, Revenue Ruling 72-49,<sup>114</sup> the latest application of the new revenue procedure, provides that advances received by telephone companies from subscribers for the following month's telephone service are not to be considered a rental of the equipment and are, therefore, properly deferrable. Considering the position taken in the above revenue ruling as well as in the new revenue procedure itself, it appears that the Commissioner is taking a liberal position with regard to advances received under agreements involving a mixture of rent and service.<sup>115</sup> It is hoped that this position will be extended to other applications of both the new revenue procedure and the new regulation.

#### *D. The Inventoriable Goods Exception*

The exception for inventoriable goods applies to the sale of goods properly includable in inventory, and provides that when a taxpayer receives a substantial advance payment (the cost of the goods to be delivered) and has on hand or available, through a normal source of supply, goods of a substantially similar kind and sufficient quantity to satisfy the agreement, all advances received must be included in income by not later than the end of the second taxable year following the year in which the substantial advance was received.<sup>116</sup> Advance payments received after the second year following receipt of a substantial advance are includable in the year

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112. Treas. Reg. § 1.61-8(b) (1957).

113. Rev. Proc. 71-21 § 3.08. Situations covered include boarding houses, apartment houses, hotel service and the like. This provision was not contained in Rev. Proc. 70-21.

114. 1972 INT. REV. BULL. No. 6, at 13. *See also* Rev. Rul. 71-299, 1971-2 CUM. BULL. 218, which, by modifying past rulings to the extent inconsistent with Rev. Proc. 71-21, in effect excludes advances for college dormitory room and board from the meaning of advance rent. Rev. Rul. 65-141, 1965-1 CUM. BULL. 210, as modified.

115. For the Commissioner's former position on cases involving rent-service mixture see cases cited note 36 *supra*.

116. Treas. Reg. § 1.451-5(c) (1971). The regulation contains a comprehensive example. *Id.* § 1.451-5(c)(4). For a good discussion of the inventoriable goods exception see Cozine & Showfety, *Advance Payments For Goods and Services*, 2 TAX ADVISOR 602 (1971) [hereinafter cited as Cozine & Showfety].

of receipt.<sup>117</sup> In the year that the advances are first included in the income the taxpayer *must* deduct the costs and expenses included in the inventory at the end of such year or, if there are no goods then on hand, the estimated cost of the goods necessary to satisfy the agreement.<sup>118</sup>

The above exception will require certain adjustments to prevent a double accounting for inventory. Although there should be no problem for larger taxpayers with sophisticated inventory control systems, smaller taxpayers must keep detailed inventory cost records. This may be done by use of a suspense account which would be kept separate throughout the life of the agreement and then closed out to ending inventory in the year of delivery.

However, there appear to be several unanswered questions surrounding the inventoriable goods exception. If, for example, the advance payments become substantial in the year in which the requisite goods are neither on hand nor available, there will be a question as to which year the taxpayer must include the advances in income. The exception could be construed to require that both elements (substantial advance and requisite goods) be present at once. By this construction, if both are not present in the same year the exception would not apply, and therefore the taxpayer would be able to defer advances until the year of delivery. A more probable construction would be to start the two year period running from the end of the first year following receipt of a substantial advance, but not before the year in which the goods are on hand or available.<sup>119</sup>

Another problem arises where a taxpayer is obligated to sell identical units to several different customers. The question is whether the taxpayer may allocate the units on hand or available over the several contracts or whether the taxpayer must use a fifo method of allocation under which all units available would be allocated to the obligation first incurred, thereby causing the two year limit to start at an earlier date.<sup>120</sup> Assuming that the taxpayer may spread the units over all of the obligations, a longer deferral will be available since the two year period will not begin to run until there are sufficient goods on hand or available to satisfy all of the obligations.

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117. Treas. Reg. § 1.451-5(c)(2) (1971).

118. *Id.* § 1.451-5(c)(1)(ii). Once these costs are deducted they are not to be taken into account again. *Id.* § 1.451-5(c)(2).

119. For a discussion of these alternative constructions see Cozine & Showfety at 604.

120. See Cozine & Showfety 605.



Still another problem not provided for in the regulation is that of discounting the price of goods to be delivered at a relatively distant future date.<sup>121</sup> A taxpayer selling caskets under a pre-need plan may charge a fifty year old customer only \$400 for a casket ordinarily selling for \$1,000. Assuming that the cost of the casket is \$500, the advances will never become "substantial" and therefore the two year limit will never begin to run. Although the use of the customer's money is the equivalent of a substantial advance, these potentially lengthy deferrals will be available only to a very limited group of taxpayers.

The sale of gift certificates is also covered by the new regulation. The inventorable goods exception applies to the sale of goods which, as in gift certificates, are not identifiable at the time of receipt of the payment.<sup>122</sup> The definition of substantial advance payments includes all advance payments received with respect to unidentifiable goods, thereby beginning the two year period upon receipt of the sale price of the gift certificate.<sup>123</sup> In addition, the cost of the goods sold under a gift certificate are not deductible until the year of redemption.<sup>124</sup> These limitations do not appear to be unreasonable in light of the fact that most gift certificates are redeemed or expire within two years. If a longer deferral is desired, the taxpayer must sufficiently restrict the subject of the certificate so that the goods will be "identifiable." However, such restricted gift certificates probably would not be very marketable.<sup>125</sup>

### *E. Application of the New Rules in Conjunction with Each Other*

It appears that the revenue procedure and the regulation could be both applicable to a transaction in which the taxpayer sells goods with an accompanying service contract. As noted above, any "incidental" replacement agreements are considered services under the revenue procedure.<sup>126</sup> The new regulation contains a reciprocal provision which is applicable where an agreement provides not only for the sale of goods, but also for the performance of services as an integral part of such sale.<sup>127</sup> Advances on such service obliga-

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121. See Sobeloff 197.

122. Treas. Reg. § 1.451-5(c)(1) (i) (1971).

123. *Id.* § 1.451-5(c) (3).

124. *Id.* § 1.451-5(c) (1) (iii).

125. For related material see Treas. Reg. § 1.451-4 and cases cited note 36 *supra*.

126. Rev. Proc. 71-21 § 3.07.

127. Treas. Reg. § 1.451-5(a) (2) (i) (b) (1971).

tions are treated as part of the sale price of the goods. Even if the services are not an integral part of the sale, deferral is permissible under the regulation to the extent that the corresponding payment is properly "allocable" to the sale of goods.<sup>128</sup> In addition, the portion of the advance payment which is not properly "allocable" to the sale may be deferred under the regulation if it amounts to less than five percent of the total contract price.<sup>129</sup> Presumably, where a service obligation meets neither the "integral" nor "allocable" tests, the advances thereunder may still be deferrable pursuant to the method prescribed in Revenue Procedure 71-21.

For example, assume that a taxpayer receives a \$200 advance payment under an agreement to sell a central air conditioning unit for \$900 and a contingent service agreement for \$100. Since the service contract is not an integral part of the sale and its price exceeds five percent of the total contract price (or \$50), the full \$200 would not be deferrable under the new regulation. However, assuming delivery in a later year, \$180 may be deferred, as that amount represents the portion (90%) of the advance allocable to the sale of goods. Had the price of the service agreement been \$40, all of the advance payment would have been deferrable pursuant to the five percent exception under the regulation. It should be noted that service agreements within the five percent exception are not subject to the revenue procedure and therefore deferrals exceeding the one year limit are permissible. Again, assuming the price of the service contract to be \$100, the portion of the advance not allocable to the sale of goods, \$20, will be eligible for deferral treatment if the service agreement fits within the requirements of Revenue Procedure 71-21. However, if the air conditioner is to be delivered in the year after the service is received, the service contract must terminate by the end of the year of delivery to be within the one year limit of the revenue procedure. Also, the air conditioner must be offered for sale without the service contract. If the agreements fit all these requirements, the entire advance payment of \$200 will be deferrable by use of a combination of Treasury Regulation 1.451-5 and Revenue Procedure 71-21.

*F. The New Deferral Methods Applied in Conjunction with the Rule of Artnell*

An interesting question is what the effect of these two new rules

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128. *Id.* § 1.451-5(a) (3).

129. *Id.*

will be on the prior case law, particularly the *Artnell* decision. Perhaps the Commissioner had in mind that the benefits provided for in the new rules will temporarily decrease litigation over the unearned income issue. The revenue procedure is merely an exercise of the Commissioner's discretion, and it should have no effect on prior case law as authority for the deferral of unearned income where the underlying agreement does not qualify under the new rules. The *Artnell* decision is still useful where, for example, a taxpayer sells three year season tickets to baseball games. Assuming similar certainty as to the *time* and *extent* of performance, the portion of the price allocable to the last two years should be eligible for deferral even though the "agreement" is not within the time limit of Revenue Procedure 71-21.

It may be possible to secure some long term deferrals by combining the principles of the *Artnell* decision and the new revenue procedure. Taxpayers, such as the elevator company in the example above, could offer two types of service contracts. One contract, drafted with *Artnell* in mind, would be long term and provide for mandatory regular preventive maintenance inspections. This contract should qualify for deferral treatment as there would be requisite certainty of the time and extent of performance. The other contract would be a contingent demand service contract renewable (but not automatically) every two years to fit within the requirements of the revenue procedure. The Commissioner will surely challenge this method and assert that in substance, irrespective of form, the two contracts constitute a single agreement. However, the taxpayer may prevail by exhibiting non-tax reasons for the separate contracts and showing that the contracts are both legally and factually independent of each other. The taxpayer could argue that there is no legal obligation to renew the contingent service contract and show that the contracts may be and sometimes are entered into without the other. Careful preparation at the planning stage will be of the utmost importance. If some of the tax savings (assuming the taxpayer prevails) are reflected in the price of the contracts, there should be no difficulty in securing the customer's assent to this arrangement. In view of the risk of disallowance, this method is suggested only as a last resort to those taxpayers having sufficient tax savings at stake to warrant litigation.

#### IV. CONCLUSION

Despite their relatively limited applicability, the new revenue procedure and regulation are certainly a step toward the reconcilia-

tion of tax and financial accounting treatment of unearned income. These new methods, even if strictly construed, will afford some relief to taxpayers seeking to defer their unearned income. Hopefully, a liberal construction will prevail, particularly with respect to the terms "all books and records" as used in the booking rule. There are some signs that the Commissioner is taking a liberal position on these rules. Revenue Ruling 72-49 and the enlarged scope of Revenue Procedure 71-21 over its predecessor in such areas as contingent service contracts and agreements involving a mixture of rent and service are indications of this policy.

It is suggested that these two new rules should be viewed as the latest in a series of step by step adoptions of the generally accepted accounting principles with more expanded rules to follow. As noted above, one of the downfalls of the ill-fated sections 452 and 462 of the Code was the resulting transition year revenue loss. This loss is being reduced by a piecemeal adoption of the deferral provisions. Irrespective of their limitations, Revenue Procedure 71-21 and Treasury Regulation 1.451-5 are welcome additions to the tax law for all taxpayers with unearned income.

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